and (5). These models typically contain several hundred, or even over a thousand, equations and variables to be forecast. In addition to the sheer difficulty of tracing the effects of so many variables, the forecasts produced by commercial forecasters generally are based also on other factors such as time-series analysis, current data analysis, and "judgment". The fact that the forecasts of these models are based significantly on judgment and current data analysis makes it very difficult for an impartial observer to reproduce the results of these models and obscures the ability to readily interpret the forecasts produced by these commercial forecasters. Commercial large-scale econometric models in general have also been criticized for failure to satisfy criterion (5) that they be internally consistent and based on sound economic foundations. In light of the five desirable characteristics listed above, it was decided that a classical general equilibrium model would be preferable to a large-scale commercial econometric model for the purpose of evaluating the effect on GNP-PI of the introduction of SFAS 106.

An additional consideration that led to the choice of the classical general equilibrium model is related to the timing of the responses to the introduction of SFAS 106. The classical general equilibrium model is intended to gauge the effects of changes after the economy has returned to equilibrium, which may take several calendar quarters or years. This model does not address the extremely difficult task of predicting the dynamic responses over the short-run. By contrast, large-scale econometric models deliver a series of quarterly forecasts of GNP and other macroeconomic variables. However, in our judgment, short-run dynamic behavior is extremely difficult to forecast. Although these models do produce short-run forecasts, we would be cautious in interpreting the timing implied by these short-run forecasts. We decided to sidestep this difficult problem by using the conservative approach of calculating the impact on the macroeconomy after the economy fully responds to SFAS 106. The sense in which this approach is conservative is that it probably will overstate the short-run impact on macroeconomic variables, and thus helps guard against understating the impact on GNP-PI.

Now we will present a detailed point-by-point response to the issues raised in paragraph 16. We will structure the responses according to the following list of requests in Paragraph 16:

(1) fully describe and document the macroeconomic model, including

- (a) the method of estimation
- (b) parameter estimates
- (c) summary statistics

(2) provide the same information as in (1) for any alternate functional forms that were used

(3) provide the data used to estimate the model

(4) provide the data used in making forecasts from the model

(5) provide the results of any sensitivity analyses performed to determine the effect of using different assumptions.

Response to request (1): fully describe and document the macroeconomic model, including the method of estimation, parameter estimates, and summary statistics.

The macroeconomic model used in the Godwins report is described verbally on pp. 27-28 of the Godwins report, and a complete mathematical derivation and description of the model is presented in Part I of Appendix C, pp. 54-57. In order to apply this mathematical model to the United States, numerical values of the parameters need to be selected. In a conventional large-scale commercial econometric model, the numerical values of the parameters are typically estimated econometrically. For these models, it is important to ask about the method of estimation, the parameter estimates, and summary statistics describing the statistical properties of the parameter estimates and the model forecasts. However, the values of the parameters used in the classical general equilibrium model in the Godwins report were not econometrically estimated in the course of the preparation of the Godwins report. Instead, the numerical values of the model were calibrated so that in the baseline calculation without SFAS 106, the numerical results produced by the model matched U.S. macroeconomic data.

The calibration procedure is described in Part II of Appendix C, pp. 58-59, but here we will present a verbal description of the calibration. The utility function of households contains the following parameters:

α_1 and α_2, which measure the relative desirability to consumers of the goods produced in sectors 1 and 2: The larger is α_1 relative to α_2, the larger is the production of good 1 relative to good 2, and the larger is the share of the labor force employed in sector 1. The values of α_1 and α_2 are chosen so that in the initial equilibrium (before the introduction of SFAS 106) 68% of the labor force is employed in sector 1 (which does not offer SFAS 106 benefits) and 32% of the labor force is employed in sector 2 (which offers SFAS 106 benefits). These figures for the shares of employment in sector 1 and in sector 2 match U.S. data as indicated on page 7 of the Godwins report. (Of the 95.8 million private sector employees, 30.7 million are eligible to have a proportion of their charges in retirement met by their employer's medical plan. Thus, the share of the private sector labor force employed in sector 2 is 30.7 million/95.6 million = 32%.)

θ, which is the elasticity of substitution between the consumption of any two goods: The parameter θ equals the price of elasticity of the demand for goods. This parameter was not estimated nor was

it directly calibrated to data. As stated on page 29 of the Godwins report, a value of 1.5 was used for θ, recognizing that this value most likely overstates the true price elasticity of demand. Experimentation with the value of θ indicated that the impact of SFAS 106 on the GNP-PI increases when the price elasticity of demand increases. (See the table on page 41 of the sensitivity analysis in the Godwins report.) Thus, using a high value of θ would guard against understating the impact of SFAS 106 on the GNP-PI.

η, which is the elasticity of labor supply: The elasticity of labor supply has been estimated econometrically in dozens of studies. Rather than try to estimate this elasticity again for the Godwins study, we referred to surveys of econometric studies of labor supply. The first complete paragraph on page 30 of the Godwins report describes the results of these studies and explains the choice of the value of zero for the labor supply elasticity.

We can amplify the discussion on page 30 by pointing out that there is an important difference between the response of labor supply to a *temporary* change in the real wage and a *permanent* change in the real wage. Economists explain the difference by using the concepts of an income effect and a substitution effect. An increase in the real wage increases the reward for working and causes people to substitute some of their time away from leisure toward working. Thus, the substitution effect of an increase in the real wage is an increase in labor supply. In addition, an increase in the real wage makes workers wealthier and reduces the need to work (or equivalently makes workers able to afford more leisure and less labor). This effect, known as the income effect, means that workers will reduce their labor supply in response to an increase in the real wage. Thus, the income effect and the substitution effect work in opposite directions: the substitution effect increases labor supply and the income effect reduces labor supply when the real wage increases. For a temporary increase in the real wage, the worker does not become very much wealthier and the income effect is relatively small. The income effect is likely to be smaller than the substitution effect and thus workers would be likely to increase labor supply in response to a temporary increase in the real wage. In contrast, for a permanent increase in the real wage, the income effect is likely to be relatively large. If the income effect is larger than the substitution effect, then workers will reduce their labor supply in response to a permanent increase in the real wage, which is a negative labor supply elasticity.

The introduction of SFAS 106 is a permanent change and thus any effects on the real wage are to be regarded as permanent effects rather than temporary effects. Thus, in choosing a value of the labor supply elasticity, it is appropriate to use the elasticity describing the response to a permanent change in the real wage. The econometric estimates described on page 30 of the Godwins

report refer to permanent wage changes, and the use of income and substitution effects explains why these estimated elasticities are somewhat negative. The impact of SFAS 106 on the GNP-PI is larger for higher labor supply elasticities, and the labor supply elasticity was set to zero in the baseline calculation to guard against understating the impact on the GNP-PI.

γ, which is the share of nominal expenditure devoted to produced goods: Given the calibration of the other parameters of the model, the value of γ does not affect the calculated effects of SFAS 106 on GNP-PI or the wage rate. As explained in Part II of Appendix C of the Godwins report, the model is calibrated so that in the absence of SFAS 106, prices in all sectors and the GNP-PI are normalized to equal 1.0. With this normalization, the value of γ becomes completely irrelevant to the numerical results of the model.

ϕ, which measures the disutility of labor: With the specification of the utility function in equation (A1) in Appendix C of the Godwins report, the labor supply curve has a constant elasticity with respect to the real wage. With a constant elasticity with respect to the real wage, the labor supply curve depends on only two parameters: the elasticity of labor supply and a location parameter. The elasticity of labor supply has already been discussed. The location parameter was chosen to make labor supply equal to labor demand as indicated in equation (B9) in Part II of Appendix C in the Godwins report. Given the labor supply elasticity and the location parameter, the numerical value of the parameter ϕ is irrelevant.

The production function contains the following parameters:

ρ_1 and ρ_2, which are the shares of labor cost in value added in sectors 1 and 2 respectively: In the baseline calculations, each of these parameters is set equal to 0.64 which is the share of labor cost in value added for the U.S. economy as a whole.

A_1 and A_2, which are productivity parameters in sectors 1 and 2 respectively: These parameters affect the demand for labor in each sector. They are calibrated so that when labor supply equals labor demand, 68% of the labor force is employed in sector 1 and 32% of the labor force is employed in sector 2. The details of this calibration are contained in Part II of Appendix C, pp. 58-59.

Response to request (2): provide the same information as in (1) for any alternate functional forms that were used.

Experimentation with different functional forms and different parameter values involves a fundamental tension. On the one hand,

experimentation with different functional forms and different parameter values offers the benefit of learning how robust the results are to various changes in the model. On the other hand, experimentation may allow the researcher to go on a "fishing expedition", fishing for the functional forms and parameter values that deliver the most pleasing result. We tried to strike the appropriate balance by not experimenting with functional forms (except as described below) and by reporting the results of experimentation with parameter values in the sensitivity analysis.

The only change in the model that might be construed as a change in functional form occurred while the model was in a developmental stage before Godwins was engaged by USTA. In the developmental stage, the original (simpler) functional form for labor supply assumed that the labor supply elasticity must be zero. However, we modified the labor supply function to its current form to allow the labor supply elasticity to be either zero or nonzero. In a sense, this change was not really a change in functional form because the original labor supply function is a special case of the labor supply function used in the Godwins report. The baseline calculations use a value of zero for the labor supply elasticity, but we decided to allow for nonzero labor supply elasticities so that we could perform a sensitivity analysis on the labor supply elasticity. The results of the sensitivity analysis are reported in section IV of the Godwins report.

The functional form used for the production functions is the Cobb-Douglas production function. This functional form is perhaps the most widely used functional form for production functions.

The functional form of the utility function was chosen so that the elasticity of labor supply and the price elasticity of demand for each good are all constant. Various constant values of these elasticities were used in the sensitivity analysis. The functional form of the utility function was also chosen to incorporate the effects on demand of the aggregate price level as well as the individual sector prices.

Response to request (3): provide the data used to estimate the model.

As explained above, the model used in the Godwins report is not an econometric model. The choice of values for various parameters was described in response to request (1)

Response to request (4): provide the data used in making forecasts from the model.

Conventional large-scale commercial econometric models are frequently used to make short-run macroeconomic forecasts of a variety of macroeconomic variables. The forecasts are *conditional* forecasts which means that the forecasts depend on the assumed future values of various input variables to the model. For such models, it is important to examine the data used in making forecasts from the model as well as

summary statistics describing historical forecast accuracy (which is related to request (1c) above).

The macroeconomic model in the Godwins report is not a conventional short-run forecasting model. The only additional data that is used to calculate the macroeconomic effects of the introduction of SFAS 106 is the direct percentage increase in labor costs for firms in sector 2. In the baseline calculations a value of 3% is used for the direct percentage increase in labor costs for firms in sector 2. In the sensitivity analysis values of 2% and 5% are also used.

Summary statistics are often used to gauge the forecasting accuracy of conventional short-run econometric forecasting models, but such statistics are not appropriate in the case of the macroeconomic model used in the Godwins report. Short-run econometric forecasting models produce forecasts of a variety of economic variables and, after the fact, the accuracy or forecast error of each forecast can be evaluated. For instance, a model could be used in 1992 to forecast GNP-PI in 1993. Then after we learn what the actual value of GNP-PI turns out to be in 1993, we can calculate the forecast error as the difference between the forecasted value of GNP-PI and the actual value of GNP-PI. Then after several years, the accuracy of the forecasts can be gauged by appropriate summary statistics of the forecast errors.

The model in the Godwins report is not a forecasting model in the same sense as the large-scale commercial econometric models. The model is not designed to forecast the actual level of GNP-PI. Instead it is designed to estimate the *change* in the level of GNP-PI that results from the introduction of SFAS 106. That is, the model is designed to calculate the difference between the actual value of GNP-PI after the introduction of SFAS 106 and the value of GNP-PI that *would have prevailed* if SFAS 106 were not introduced. Even after the fact, when we observe the actual value of GNP-PI in the presence of SFAS 106, we will not be able to assess the accuracy of the model in the standard way. Remember that the model produces an estimate of how much different GNP-PI is as a result of the introduction of SFAS 106. To assess the accuracy of this estimate we would need to know the actual level of GNP-PI after the introduction of SFAS 106 and we would also need to know the value that GNP-PI would have had if SFAS 106 were not introduced. Even after the fact, we cannot observe or directly measure the level that GNP-PI would have taken in the absence of SFAS 106. Thus traditional measures of forecast accuracy cannot be used to assess the accuracy of the model in the Godwins report.

Three additional remarks are in order at this point. First, the model is specifically designed not to be a forecasting model but instead to focus on how much different GNP-PI is as a result of the introduction of SFAS 106. This focus is exactly the question at issue in the Godwins report.

Second, the fact that the model in the Godwins report cannot be evaluated by the traditional measures of forecast accuracy does not mean

that the model cannot be checked against reality. The parameters in the model were calibrated so that the values of labor share of total cost, and the share of employment covered by SFAS 106 produced by the model matched up with actual values of these numbers.

Third, our confidence in the model's numerical results is bolstered by the sensitivity analysis which indicates that our results are quite robust to changes in the values of the model's parameters.

Response to request (5): provide the results of any sensitivity analyses performed to determine the effect of using different assumptions.

As mentioned above, Section IV of the Godwins report, pp. 34-43, is devoted to the sensitivity analysis. In particular, pp. 37-39 specifically discuss the sensitivity analysis of the macroeconomic model. The numerical results of the sensitivity analysis are presented in the table on page 41.

Attachment E - 1992 Rebuttal Analysis for Godwins Study

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

92-101

In the Matter of:	)	
	)	
Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions"	)	CC Docket No. ~~91-201~~
	)	
Bell Atlantic Tariff FCC No. 1	)	Transmittal No. 497
	)	
U S West Communications, Inc. Tariff FCC Nos. 1 and 4	)	Transmittal No. 246
	)	
Pacific Bell Tariff FCC No. 128	)	Transmittal No. 1579

REBUTTAL TO OPPOSITIONS TO DIRECT CASE OF THE UNITED STATES TELEPHONE ASSOCIATION

Martin T. McCue
General Counsel

Linda Kent
Associate General Counsel

900 19th Street, NW, Suite 800
Washington, D.C. 20006-2105
(202) 835-3100

July 31, 1992

SUMMARY

USTA provides a detailed response to the objections raised by the opposing parties prepared by Godwins regarding its study. The response clearly refutes the objections and demonstrates that the Bureau can rely on the soundness of the study and the validity of its results in recognizing OPEB costs as exogenous for price cap purposes.

USTA also rebuts assertions made that OPEB costs have already been reflected in the Commission's latest represcription.

TABLE OF CONTENTS

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of:	)	
	)	
Treatment of Local Exchange Carrier Tariffs Implementing Statement of Financial Accounting Standards, "Employers Accounting for Postretirement Benefits Other Than Pensions"	)	CC Docket No. 91-101
Bell Atlantic Tariff FCC No. 1	)	Transmittal No. 497
U S West Communications, Inc. Tariff FCC Nos. 1 and 4	)	Transmittal No. 246
Pacific Bell Tariff FCC No. 128	)	Transmittal No. 1579

REBUTTAL TO OPPOSITIONS TO DIRECT CASE
OF THE
UNITED STATES TELEPHONE ASSOCIATION

The United States Telephone Association (USTA) respectfully submits its Rebuttal to the Oppositions to Direct Case which were filed July 1, 1992 in the above-referenced proceeding.

I. INTRODUCTION.

In its Direct Case, USTA supported the exogenous treatment of the incremental costs of implementing Statement of Financial Accounting Standards -106 (SFAS-106), "Employers Accounting for Postretirement Benefits Other Than Pensions" (OPEB). USTA commissioned the Godwins study, "Post-Retirement Health Care Study Comparison of TELCO Demographic and Economic Structures and Actuarial Basis National Averages" (1992). That study analyzes the impact of SFAS-106 on GNP-PI and, in particular, the extent to which the GNP-PI will reflect the increase in costs

experienced by exchange carriers as a result of implementing SFAS-106. The study shows that the impact of implementing SFAS-106 will not be double-counted within the context of the price cap formula.

In Oppositions filed July 1, 1992, AT&T, MCI, Ad Hoc Telecommunications Users Committee (Ad Hoc) and ICA attempted to raise objections to the Godwins study. MCI, Ad Hoc and ICA also allege that the impact of implementing SFAS-106 was reflected in the latest Commission represcription of exchange carriers' rate of return. USTA will refute these points in its Rebuttal.

II. GODWINS STUDY.

Attached hereto is a detailed response to the objections raised by the opposing parties prepared by Godwins. The response clearly refutes the objections and demonstrates that the Bureau can rely on the soundness of the study and the validity of its results in recognizing OPEB costs as exogenous for price cap purposes.

The response first discusses the issue of double counting. The Godwins study addresses double counting which could occur in the increases in the PCI due to increases in the GNP-PI caused by companies with OPEB liabilities reflecting those costs through higher prices. No opposing party casts doubt on any of the basic findings of the study. Therefore, the Bureau should adopt the study's conclusion that double counting could account for 0.7

percent of the increase in costs attributable to SFAS-106, that 14.5 percent of the increase could be recovered through a reduction in the national wage rate and that the remaining 84.8 percent of the increase in costs are exogenous.

The response clarifies a misconception of the opposing parties by explaining that it is the increase in expense due to the SFAS-106 accounting change that should be afforded exogenous treatment, and not the SFAS-106 expense.

The response explains that the alternatives suggested by opposing parties to determine the extent of double counting do not even address the true source of potential double counting.

Second, the Godwins response refutes objections raised regarding the actuarial analysis. Godwins points out that AT&T's contention that the study is flawed because the government sector is excluded is based on a misstatement of fact. MCI's criticism regarding the use of data from only one insurance company only demonstrates that MCI failed to appreciate the validity of the data and how it was utilized in the study. Godwins also addresses Ad Hoc's contention that it did not include the effect of "standard error".

The response supports the reasonableness of the actuarial assumptions utilized in determining the ratio of GNP-BLI to TELCO-BLI. In addition, Godwins reaffirms its finding that labor

costs of non-exchange carrier firms sponsoring retiree medical plans will increase 3.19 percent as a result of SFAS-106.

Godwins also responds to objections regarding the macroeconomic analysis.

Finally, Godwins rebuts the report prepared by Economics and Technology, Inc. (ETI). As Godwins explains this report is unprofessional in that it contains numerous misrepresentations and distortions.

III. RATE OF RETURN REPRESCRIPTION.

The opposing parties have missed the point in assuming that the latest Commission represcription of rate of return made exchange carriers whole.[1] Specifically, ETI contends that exchange carriers have ignored economic effects to the extent that SFAS-106 liabilities were reflected in RBOC share prices as used by the Commission in setting the rate of return. MCI states that SFAS-106 costs were embedded in the initial price cap rates and that to provide exogenous treatment for these costs would result in double counting. This claim is supported in an affidavit attached to MCI's filing by Professor Allan Drazen.

In stating these claims, the opposing parties are simply making the wrong argument on several counts. First, they have ignored the fact that exchange carriers are regulated on their

---

[1] See, Comments of Ad Hoc at p.17 and MCI at pp.11-17.

accounting records. In monitoring a company's books, the regulator must recognize any change in accounting rules that affects the company's earnings which is not otherwise accounted for and make an adjustment for the change. The regulator, by setting a fair rate of return, has not obviated the obligation to compensate the company for any reasonable and necessary expenditures.

Second, the opposing parties have completely missed the link between risk and return. They have not shown any changes in the cost of capital caused by changes in company risk or changes in capital market conditions. They have simply contended that a postulated change in the stock price of a company automatically implies a change in the cost of capital. Their arguments are both unsupported and erroneous. Changes in the cost of capital are caused by changes in risk, not simply by a change in stock price, as the opposing parties contend. In fact, the Commission has stated that "(a)n increase in the price of a stock, however, may leave the stock's expected return unchanged if the price rose to adjust for higher anticipated profits rather than lower investor perceived risk."[2]

The existence of post-employment medical liabilities is not new to analysts and investors. The extent to which these

---

[2] Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers, CC Docket No. 89-624, Order, 5 FCC Rcd 7507, released December 7, 1990 at paragraph 133.

liabilities were incorporated in the stock price of a company was not affected by or based on the adoption of SFAS-106. Such liabilities were always an economic reality. The only thing the adoption of SFAS-106 did was to affect the accounting of these costs and, potentially, the recovery of these costs through rates. If stock prices were reduced by these liabilities, it was not due to SFAS-106. Further, even if stock prices were reduced by expectations, the need for exogenous treatment has not been eliminated.

As the Commission was considering the represcription of rates for exchange carriers, recovery of SFAS-106 costs was a reasonable expectation of the investment community. Exchange carriers expected that changes to GAAP would be exogenous and that an accrual account for retiree nonpension benefits would require a GAAP change. The record before the Commission reflected a consensus on this issue:

> USOA Changes. All those commenting on the treatment of costs attributable to changes in our Uniform System of Accounts agree that these costs should be considered exogenous. ... Nonetheless, because changes in GAAP cause changes in the regulatory accounting procedures of carriers under our jurisdiction only after we find such changes compatible with our regulatory accounting needs, we conclude ... that AT&T should adjust its price cap to reflect such changes in GAAP only after we have approved such a change. We now propose the same treatment of GAAP changes for the LECs.[3]

Exchange carriers expected that accrual accounting for

---

[3] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Report and Order and Second Further Notice of Proposed Rulemaking, 4 FCC Rcd 2873, released April 17 1989, at paragraph 654.

retiree nonpension benefits would require a GAAP change.

The Commission did not further address exogenous cost treatment of either GAAP changes, USOA changes or SFAS-106. Thus, no indication was given to investors by the Commission that price cap exchange carriers would not receive exogenous cost recovery for the incremental SFAS-106 costs imposed by the GAAP change. In fact, it was expected that price cap exchange carriers would obtain increased revenues to cover the increased costs of SFAS-106 implementation.

The ETI report states that SFAS-106 costs "were reflected in the share prices of the LEC and other firms evaluated by the FCC for the rate of return represcription upon which the LEC price cap plan was based" and that "the Commission should fairly conclude that SFAS-106 effects already are discounted to some degree in the existing nationwide average rate of return prescribed for all carriers."[4] ETI supports this statement by noting that "a large data base of health care prices, costs, employee contributions and co-payments, eligibility requirements, deductibles and other insurance requirements" was available to "actuaries, securities analysts, insurance and benefits consultants and any other analyst who may have cared to compute potential long-term health care costs for any segment of the

---

[4] Opposition of the Ad Hoc Telecommunications Users Committee to Direct Cases, filed July 1, 1992, at Appendix I, p.2.

population."[5]

In addition, the ETI report states that:

> the FCC's represcription of the industry-wide rate of return for LECs explicitly relied upon Institutional Brokers Estimate Service (IBES) data on dividends, earnings and stock prices as part of the discounted cash flow analysis used to establish the prescribed return on equity. IBES data were determined by the FCC to be a reasonable expectation of investor expectations.[6]

The ETI report neglects to point out that if the prospect of SFAS-106 costs would impact stock prices, it should also impact dividend and earnings growth expectations, for it is these very expectations which affect stock prices. It follows then that, just as the pressure on stock prices would presumably be downward, so would the impact on dividend and earnings growth expectations (absent exogenous treatment, obviously). Therefore, if stock prices are lower and if dividend and earnings expectations are lower, it is entirely possible, even likely, that the cost of equity would be largely unaffected, certainly not higher as ETI contends.[7]

MCI makes the same error as ETI. Both consider one variable in the equation, that is, purported stock price effects. Curiously, however, they do acknowledge the impact on earnings expectations, but not in any quantitative way, when they state

---

[5] Id. at p.11.

[6] Id.

[7] The opposing parties all reference the Discounted Cash Flow (DCF) analysis when discussing the cost of equity, whereby cost of equity is the sum of the dividend yield and expected growth in dividends.

that "(a)ny negative consequence to earnings or profitability caused by the expectations of SFAS-106 costs was recognized by the market participants and resulted in downward adjustment to the price of the stock."[8] This lack of recognition of the "negative consequence to earnings" is amply demonstrated in the affidavit prepared by Professor Drazen where the author refers only to "the effect that the anticipated adoption of SFAS-106 may already have had on the price of the LECs' stock and hence on the rate of return to capital on which current rates are based."[9]

Apparently Professor Drazen is not completely unaware of the effect on growth expectations, as he goes on to state:

> (t)he cost of equity calculated by the DCF formula is the sum of the dividend yield and an estimate of the long-term growth in dividends G. A future regulation such as SFAS-106, which is anticipated to induce a discrete downward adjustment in accounting profits when first adopted but whose exact initial impact is uncertain, should have a clear effect in reducing the stock price but a far less clear effect on estimates of G.[10]

Drazen further contends that:

> when there is agreement on the direction of the effect of a regulation on profitability, but uncertainty about its exact impact before it is adopted, there will be a fall in the stock price, and hence an increase the yield (sic) and in the cost of equity as measured by the DCF formula before the regulation is adopted.[11]

---

[8] Opposition of MCI Telecommunications Corp. Direct Cases, filed July 1, 1992, at Appendix A, p.15. [MCI Appendix A.]

[9] Id. at p.2.

[10] Id. at p.3.

[11] Id. at p.4.

Is the Commission to believe, then, that because there is purportedly uncertainty regarding the magnitude of the effect on G, it is to be ignored? Surely, without adequate rate recovery, there is no such uncertainty regarding the direction of the impact on G. In fact, later on, Professor Drazen admits there is some uncertainty in the measure of the "increase in the present discounted value of anticipated retiree health liabilities" presented in the referenced Mittelstaedt and Warshawsky study [Warshawsky] when he allows "(t)his estimate has a large confidence interval however."[12] He further states that "(t)he Warshawsky estimates suggest that with the high degree of uncertainty regarding the impact of SFAS-106 before it was adopted, there was a clear depressing effect on stock prices."[13]

It is, therefore, hard to reconcile this admitted "uncertainty" and "large confidence interval" with Professor Drazen's premise that there will be a "clear effect in reducing the stock price"[14] and his decision not to incorporate any effect on dividend and earnings growth expectations. Clearly, this sort of implementation of the DCF would lead to upwardly biased estimates of the cost of capital and not a "true" adjustment to the cost of capital as postulated by the author.

The Warshawsky estimates are founded on unsupported

---

[12] Id. at p.5.

[13] Id.

[14] Id. at p.3.

assumptions, which may be the reason for the lack of statistical robustness in the results. The authors themselves admit this imprecision in their own abstract. "(R)esults suggest that market estimates of the liabilities are imprecise. To the extent that the imprecision is due to insufficient accounting disclosures, significant price adjustments, upward and downward, may occur when information required by a new accounting standard is disclosed."[15]

Drazen's contention that "(t)he possibility that an anticipated future cost increase will be reflected in a higher current cost of equity is noncontroversial in theory,"[16] is contradicted in the same article used in Warshawsky's paper:

> Although many corporate executives concede that the new rule would slash reported earnings and reduce book values substantially, the FASB proposal so far has caused little stir on Wall Street. ... Shrugs Lee Seidler, an accounting specialist with Bear Stearns, "It will be a big yawn."[17]

Additional evidence on the lack of consensus among analysts and investors of the impact of SFAS-106 on stock prices at the time of the Commission's represcription is evident in the same article:

---

[15] M. Warshawsky, "The Impact of Liabilities for Retiree Health Benefits on Share Prices," Finance and Economics Discussion Series paper 156, Division of Monetary Affairs, Federal Reserve Board, Washington, D.C., April 1991, Abstract. (Emphasis added.)

[16] MCI Appendix A at p.4.

[17] Henriques, Barron's, April 17, 1989 at p.8.

> Only about a fourth of the corporations surveyed in Foster Higgin's annual health care benefits survey have even a rough idea of what their potential liabilities would be under the FASB proposal, says Pat Wilson. "Do they know the general magnitude? Yeah, they have a feel for it. They know if it's bigger than a bread-box, smaller than a battleship. But do they know what the effect will be on their income statement over time? No. The percentage that really knows that is much, much lower."
>
> But, however slow corporations have been to assess the potential consequences of the FASB rule, they're leagues ahead of Wall Street.
>
> "I don't think anyone even has a good idea of how to start dealing with this, how to develop the logic by which they can anticipate who would be affected," admits Robert Willens, a senior vice president at Shearson Lehman Hutton. There's a large body of people who think this will never get implemented, so they just haven't given it much thought."[18]

The sole quote relied on by Warshawsky, by an analyst at Salomon Brothers, was immediately followed in the article by this statement:

> Willens doesn't buy that. "I don't see how that could be the case when people are just now beginning to get an idea of the potential implications," he protests. "They're not even close to being reflected in the stock price."[19]

The underlying weakness in all of the arguments made to support the view that the cost of capital, as estimated by the Commission, already contains a premium to account for SFAS-106 costs is quite straightforward. Any perceived stock price effects are caused by possible changes in dividend and earnings growth assumptions. The stock price effects do not materialize on their own, the two go hand-in-hand. Even Professor Drazen

---

[18] Id.

[19] Id. at p.9.

acknowledged this linkage when he states that "(e)fficient markets theory argues that a future anticipated change in cost and hence earnings will be reflected in current stock prices."[20] The opposing parties have taken a postulated change in stock prices and imputed a change in cost of capital completely at odds with the literature they cited and with the Commission's own statements and in violation of their reliance on the DCF method to estimate the cost of equity.

IV. CONCLUSION.

Based on the foregoing, USTA urges the Commission to recognize OPEB costs as exogenous for price cap purposes.

Respectfully submitted,

UNITED STATES TELEPHONE ASSOCIATION

By 

Martin T. McCue
General Counsel

Linda Kent
Associate General Counsel

900 19th Street, NW, Suite 800
Washington, D.C. 20006-2105
(202) 835-3100

July 31, 1992

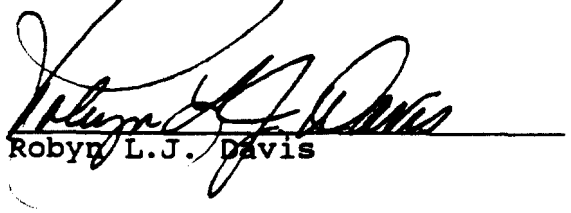
Attachment

---

[20] MCI Appendix A at p.3.

CERTIFICATE OF SERVICE

I, Robyn L.J. Davis, do certify that on July 31, 1992 copies of the foregoing Rebuttal to Oppositions to Direct Case of the United States Telephone Association were either hand-delivered, or deposited in the U.S. Mail, first-class, postage prepaid to the persons on the attached service list.



Robyn L.J. Davis